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Outline for Remarks by Al Varner
Senior Director, Regulatory, Policy and Planning
BellSouth Telecommunications
As prepared for delivery to
Federal-State Joint Board on Universal Service
Washington, D. C.
September 13, 1996

1. The CCL is designed to recover a portion of the loop costs assigned to the interstate jurisdiction. These are real costs based on the network presently used to provide local exchange service. The entire CCL represents support for universal service.

– The CCL, by recovering a portion of local loop costs, has effectively allowed local rates to be lower than would otherwise have been the case.

– BellSouth has quantified the size of the difference between the revenues and embedded costs for universal service for all large companies. In all cases, this difference, which includes providing the loop, exceeds the amount of CCL revenue received by these companies. Using reasonable proxy cost models, such as the BCM2, the overall amount of support is still greater than the CCL revenue.

– The CCL represents traffic sensitive recovery of non-traffic sensitive costs. It will not be sustainable in a competitive environment.

2. To the extent these costs are not recovered from the interstate jurisdiction, cost recovery would necessarily fall back onto the states and eventually to end users.

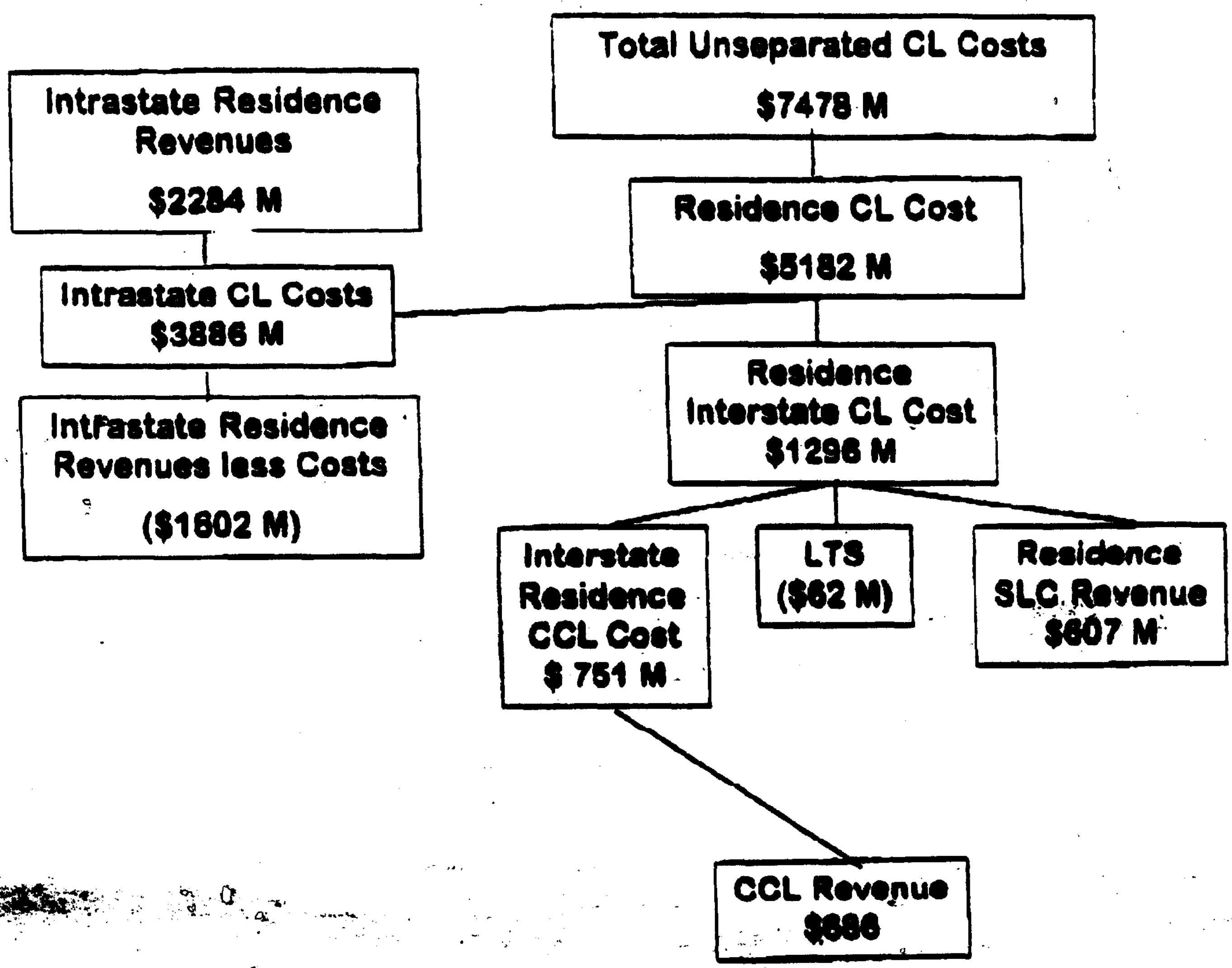
3. Going forward there are several ways to deal with these costs.

a) through a universal service funding mechanism funded by all interstate telecommunications carriers.

b) shift the cost to the end user.

c) a combination of these two.

## BellSouth Illustration of Common Line Revenues and Costs



## NATIONWIDE COMPARISON OF UNIVERSAL SERVICE REVENUES AND COSTS

| | |
|---|---|
| Estimated Total Universal Service Costs (Core Services) | $31.1 B |
| Estimated Total Universal Service Revenues | $17.9 B |
| Estimated Total Universal Service Support | $13.2 B |
| Total Revenues from Interstate CCL, Interstate RIC, existing Universal Service Fund, DEM Weighting and Long Term Support | $ 7.7 B |

Exhibit 7 from NYNEX's Petition for Waiver filed December 15, 1993 - NYNEX Transition Plan to Preserve Universal In A Competitive Environment

# Separations' Legacy of Subsidy

By Albert Halprin

## I. INTRODUCTION

In CC Docket 91-213, the Commission identified a large disparity between the amount of costs that are allocated to the interstate Local Transport category under the FCC's separation and access charge rules and the amount of costs that are recovered when special access rates are applied to recover the costs of local transport facilities. Some commenters, alleging that this disparity represents the presence of uneconomic costs in the Local Transport category that are the product of "waste and inefficiency," argue that the disparity should be disallowed or phased-down over time.

This paper provides a historical context illustrating that the excess costs in Local Transport and other federal accounts are not examples of LEC inefficiencies, but vestiges of decades of FCC and Joint Board decisions that deliberately and systematically overallocated costs to the interstate jurisdiction to subsidize local rates. This history, particularly as it relates to the [illegible] of today, makes it vital to find a reliable and efficient mechanism for recovery of these costs.

## II. BACKGROUND

While separations procedures are ostensibly designed to merely apportion telecommunications costs between interstate and intrastate jurisdictions, they are inherently subject to regulatory manipulation to further non-economic, policy goals. This is primarily due to the fact that the vast majority of the costs to be apportioned are joint and common.

As the FCC recently explained,[1] the separations process[2]:

> apportions costs between the interstate and intrastate jurisdictions by one of two basic procedures: direct assignment and allocation. In general, the cost of a facility is directly assigned to a specific category or jurisdiction whenever the cost is readily identifiable as belonging to that category or jurisdiction. Direct assignment generally is prescribed by rules only when a facility exclusively performs one function or serves one jurisdiction, thereby making cost identification easy. Direct assignment, in practice, applies to less than 5 percent of industry total costs when the categorized costs are being separated between state and interstate services. At least 95 percent of total costs are common or joint with respect to these services, making it difficult or impossible for carriers to attribute costs to specific services in a manner reflecting cost causation. Consequently, almost all of the total costs are apportioned between the jurisdictions using an allocation procedure.
>
> Both in principle and practice, allocation is different from direct assignment. Whereas direct assignment always reflects cost causation, allocation may not .... Allocation typically is based on prescribed relative usage factors that the Commission believes will provide a reasonable approximation of the results that would be achieved if it were possible to perform an assignment based on causation. Even the best factors, however, yield only a rough approximation of the costs actually incurred by state and interstate services. Moreover, if no relationship exists between relative usage and cost causation, allocation generally is not based on relative usage. Instead, it is based on a gross factor, such as the 25 percent SLC [sic] that was used to allocate a portion of local loop costs to interstate operations.

As a result of these constraints, the separations and access charge rules typically (1) allocate most costs among broad categories of plant and equipment rather than assigning costs on a

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1/ FCC Access Reform Task Force, Federal Perspectives on Access Charge Reform: A Staff Analysis 65-66 (April 30, 1993) ("Access Charge Reform Report") (footnotes omitted).

2/ Separations is part of a four-step cost-recovery process for LECs. First, carriers segregate total costs into various accounts in accordance with the Uniform System of Accounts (Part 32 of the FCC Rules). Second, these accounts are divided between regulated and nonregulated services in accordance with the Joint Cost Rules (Part 64). Third, the regulated costs are separated between the intrastate and interstate jurisdictions as specified by the Separations Manual (Part 36). And fourth, the interstate costs are apportioned among access elements in accordance with the access charge rules (Part 69).

cost-causative basis[2] and (2) rely on broad allocators to assign costs. The result does not necessarily reflect the costs that telephone companies incur to provide each service and it masks any misallocations of costs between jurisdictions.

As illustrated more thoroughly below, these characteristics have provided, and continue to provide, a regulatory mechanism that introduces significant contribution flows (revenues exceeding the directly-identified costs for such services) from interstate switched and transport access accounts to local residential exchange service. The convergence of various political and technological developments, beginning in the 1950s and lasting at least through the 1970s, made such manipulation irresistible. And even during the more fiscally responsible 1980s when competition in the telecommunications industry was becoming a reality, the FCC and the Joint Board frequently used the separations procedures to perpetuate the subsidy of local rates by interstate services.

While a certain mythology has arisen that the access charge and separations changes of the 1980s "solved" these problems, that assessment is far from the truth. The goals of those reforms were much more modest. They were merely to prevent the continuing growth in misallocation to the interstate jurisdiction, including a rollback of [illegible] subscriber plant factor (SPF), and to begin a program of collecting the misallocated amount in a reliable and efficient way.

[2] For example, the separations rules allocate general support facilities costs (land, buildings, motor vehicles, furniture and other overhead expenses) between the jurisdictions based on combined Big Three Expenses (plant specific expenses, plant non-specific expenses, and customer operations expenses). NYNEX, Local Transport Rate Restructure Interconnection Charge Contribution Analysis, CC Docket 91-213, at 5 (July 24, 1993)("NYNEX RIC Analysis").

Prior to these actions, the emphasis had only been on reliability. The access charge proceeding determined that per minute loadings on interexchange carriers were neither reliable (because they gave rise to bypass) nor efficient (because they gave rise to toll suppression). In taking these steps, the Commission considered and rejected a series of alternative approaches to the problem that would have essentially involved "washing its hands" of responsibility for reliable and efficient recovery and reallocating virtually all of these costs to the states (the so-called "zero" or "zero plus" allocation plans). The Commission correctly determined that it could not fulfill its obligation to ensure a reliable "rapid, efficient Nation-wide" network without addressing and beginning to solve recovery issues as well.

The impact of beginning to address the "reliability" issue is hard to overstate. By changing the separations mechanism from one in which the sole policy driver was subsidizing local service to a more complicated formula, the Joint Board process initially generated considerable federal-state friction and became a lightning rod for Congress. In this environment, concerns about the potential impact of any separations changes on state revenue requirements were made both more explicit and more pervasive than in the days when the whole process was implicitly and exclusively focused on subsidy. No change -- no matter how technical -- could even be considered without scrutiny of its potential impact on state revenue requirements.

## III. 1940s-1970s: THE HEYDAY OF OVERALLOCATION

In its 1930 decision Smith v. Illinois Bell, the Supreme Court ruled that some fraction of each local telephone company's costs could be allocated to interstate accounts under the federal jurisdiction.[4] Making precise apportionments was extremely difficult and, as a result, it took federal and state regulators the next 17 years to put this interstate allocation into practice, culminating in the advent of the first Separations Manual in 1947.

Over time, it became increasingly attractive for all parties concerned to use the ambiguities inherent in the broad allocators of separations to subsidize local rates by artificially maintaining high long distance rates or having such rates decline more slowly than the decreases in underlying costs.[5] Local regulators supported this practice because their constituents' local rates were kept low. The FCC gained political credit by advancing its universal service goals. And although pre-divestiture AT&T's Long Lines was forced to charge inflated rates to reflect the misallocation of such costs, it was not harmed because (1) rate of return regulation enabled it to recover additional revenues from any such inflated costs, and (2) it faced no competitive pressure to price its services to reflect their true costs.

Advances in long distance technology made it even easier to use separations to overallocate costs to the interstate jurisdiction. Since such advances rapidly decreased true interstate costs, it became possible to shift an even greater disproportionate share of costs onto the interstate jurisdiction, through the use of various separations allocators. The sharp decline in the underlying costs of providing long distance service still made it possible for long distance rates to decline, although not as rapidly as if there were no separations

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4 282 U.S. 133 (1930). Specifically, the Supreme Court ruled that the cost of interstate plant had to be separated from the costs of intrastate plant before state-approved rates could be determined from the telephone company's costs. "[U]nless an apportionment [based upon actual use of the property] is made, the intrastate service to which the exchange property is allocated will bear an undue burden." Id. at 150-51.

5 The states generally follow a similar practice in pricing toll calls within their borders.

overallocation. At the same time, the overallocation allowed local rates to remain low. Indeed, it has been said that Bell Labs' "record of relentless technological improvements was the glue that held together AT&T's various accommodations with the state and federal governments."[6] The successive increases in these allocations to the interstate jurisdiction channeled the improved efficiency of the Bell System into lower local rates.

For a time, this policy was extremely successful. By imposing on long distance callers costs that reached approximately seven billion dollars annually,[7] the transfer made a major contribution to the fifty-five percent decline in real terms of the price of basic local service between 1940 and 1980.[8] And that, in turn, helped raise the proportion of households subscribing to telephone service from thirty-seven percent in 1940 to more than ninety-two percent by 1986.[9] As described more thoroughly below, however, divestiture and, more precisely, the advent of competition eventually created marketplace pressures that made many of these misallocations untenable.

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6/ Temin, The Fall of the Bell System: A Study in Pricing and Politics 19? (1987).

7/ Id. at 357 citing Temin & Peters, "Cross-Subsidization in the Telephone Network." 21 Willamette Law Review 199-223 (Spring 1985); see also Kahn & Shew, "Current Issues in Telecommunica-tions Regulation: Pricing" 4 Yale J. on Reg. 191, 194-95 (1987)(estimating the peak annual contribution from intrastate and interstate toll of local service was $11 billion).

8/ Kahn & Shew at 195 citing AT&T Economic Analysis Section, Relative Costs of Telephone Service 1940-1980 (1980).

9/ Id. citing U.S. Department of Commerce, Bureau of the Census, Statistical Abstract of the U.S. 495 (90th ed. 1969) and Telecomm. Rep. June 2, 1986 at 6.

## A. The Early Years

Between 1939 and 1942, the number of telephone messages carried by AT&T Long Lines soared from 60 to 114 million thereby raising its profits significantly.[10] Alarmed, the FCC asked AT&T to show cause why its interstate rates should not be reduced.[11] AT&T responded that lower rates would only encourage civilians to increase their calling and AT&T was already struggling to handle the increased volume of war-related traffic. AT&T's response presented the FCC with the dilemma of how to reduce Long Lines' profits without reducing its rates.[12]

Drawing on the Smith decision, the FCC decided to increase Long Lines' costs by adding charges for the cost of capital used in completing interstate calls through the equipment of the local operating companies.[13] Long Lines' profits would thereby be lowered and local service costs that had been covered by intrastate rates would also fall. The decline in local rates would encourage universal service. Separating interstate and intrastate costs along these lines solved the immediate problems of Long Lines' profits and war-time demand as well as created a mechanism to address the jurisdictional divisions required by Smith. It was an opportunity too good to be missed.

However, there was still the problem of calculating the proper allocator for apportioning local capital costs that did not vary with use (nontraffic sensitive or NTS)

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[10] Temin at 20.

[11] Rates and Charges for Communication Services Furnished by its Long Lines Department, FCC Docket 6468 (November 20, 1942) cited in Temin at 20.

[12] Statement of Walter S. Gifford, November 21, 1942 cited in Temin at 20.

[13] Temin at 22.

between local and long distance services. The 1947 Separations Manual mandated that AT&T separate its costs and capital stock into intrastate and interstate categories, calculate the revenue requirements of the two parts of the separated capital stock, and divide the revenues received between Long Lines and the local telephone companies (both Bell and independent) in accordance with these revenue requirements.[14] The expenses of the local exchange plant were divided between interstate and intrastate jurisdictions on the basis of relative use measured by "subscriber line use" or "SLU."[15]

By 1950, there was an increasing gap between the rates charged by Long Lines for interstate toll calls and the rates charged by local telephone companies for comparable intrastate calls. State regulators worried about this "toll rate disparity" which continued to grow as local rates rose in the postwar inflation.[16] Larger separations payments would provide the opportunity for state regulators to lower intrastate rates and reduce the toll rate disparity. It would also allow AT&T to increase its earnings by transferring some of the Bell System's capital to the interstate jurisdiction where the FCC allowed higher rates of return than most states.

The FCC initially resisted any deviation from SLU, arguing that proposals to shift more local plant costs into the interstate rate base "would have the effect of introducing an arbitrary method whereby interstate services subject to Federal jurisdiction would, in effect, be

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[14] Separations Manual, October 1947 cited in Temin at 24.

[15] SLU is defined as "the time the local plant was used for interstate calls divided by its total time in use." Temin at 23-24, n. 28.

[16] NARUC-FCC Toll Rate Subcommittee, Message Toll Telephone Rates and Disparities July 1951 cited in Temin at 24.

subsidizing services beyond that jurisdiction."[17] However, Senator Ernest McFarland, the chairman of the Senate subcommittee overseeing the FCC, responding to appeals from state regulators, wrote the FCC, expressing his dismay at the Commission's willingness to "shift the load from the big user to the little user; from the large national corporations which are heavy users of long distance to the average housewife and business or professional man who do not indulge in a great deal of long distance."[18] The FCC eventually acquiesced to the political pressure with the resulting revision to the Separations Manual shifting enough revenue requirements to interstate operations to justify the first interstate rate increases granted since the creation of the FCC.[19] These rate increases took place while technological progress was reducing the cost of long distance service and rising wages were raising the cost of labor-intensive local services. This and subsequent manipulations of the separations process sharply reduced the toll rate disparity and sharply increased the subsidy that flowed from long distance to local service.[20]

B. The Modified Phoenix Plan and the Denver Plan

Of significance to understanding the existence and size of the current Local Transport disparity was the "Modified Phoenix Plan" ordered in 1956. This plan increased the interstate assignment of interoffice plant through the inclusion of AT&T's transmitting plant in the Associated Companies' (i.e., the BOCs') interstate costs. Specifically, the Modified Phoenix

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[17] Letter from P. Walker to M. McWhorter dated October 18, 1950 cited in Temin at 24.

[18] Letter from E. McFarland to P. Walker dated January 30, 1951 cited in Temin at 25.

[19] Temin at 25.

[20] Id. at 25-6.

Plan provided that the book costs of Long Lines plant terminating in each state be combined with the Associated Company toll lines plant in the state. The combined total investment was apportioned between state and interstate jurisdictions on the basis of relative message-minute-miles. At the time the plan was proposed, it was estimated that it would transfer $162 million of investment and $18 million of expenses from state to interstate operations, equivalent to a reduction in state toll costs of about 22 percent.[21] "It is fair to conclude that the entire operation, the so-called Modified Phoenix plan, resulted in a transfer of Bell System earnings from the interstate pocket to the intrastate pocket. The collective trousers, of course, [were] worn by the same corporate body."[22]

In 1969, the FCC "undid" the Modified Phoenix Plan by calling for the removal of AT&T's transmitting plant from the Associated Companies' averaging of interstate costs. Although this decreased the average interoffice costs to the interstate jurisdiction by removing high volume/low cost transmitting plant from the equation, four years earlier the procedures adopted in the "Denver Plan" had increased the interstate assignment of exchange trunk plant, thereby negating the reduction from undoing the Modified Phoenix Plan.[23] According to

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[21] R. Gabel, Development of Separations Principles in the Telephone Industry at 82 (1967) citing Interim Report of Separations Subcommittee, 1954 Proceedings at 281.

[22] Gabel at 91-92.

[23] Specifically, under the Denver Plan procedures, the book costs of subscriber lines and station equipment were apportioned on a new composite use-user factor. The use factor represented total originating plus terminating minutes of use, adding data for manual offices. The user factor was derived by obtaining the ratio of toll users to total users and multiplying this quantity by the ratio of interstate to total toll messages. The combined interstate use-user factor was then applied to the book cost of subscriber lines and station equipment to obtain interstate assignment. In addition, the book costs of local dial switching equipment were apportioned on the dial equipment minutes (DEM) factor (relative minutes of dial equipment (continued...)

AT&T calculations, the Denver Plan changes effected a transfer of about $401 million in book costs, $62 million in expenses, and $98.5 million in revenue requirements to interstate operations.[24] From that time to the present, the rules, particularly those related to interoffice plant, have been a product of attempting to artificially equalize costs between the state and interstate jurisdictions.

## C. THE OZARK PLAN AND THE 1970s

Perhaps the most conspicuous use of the separations process as a cost recovery, rather than merely a cost allocation, mechanism occurred with the FCC's adoption of the Ozark Plan in 1971. This revision of the Separations Manual introduced the concept of the SPF, which was computed from SLU but which allocated an even greater part of local plant costs to interstate service.[25] Under this Plan, subscriber plant costs were allocated pursuant to a formula that had the effect of assigning approximately 3.3 percent of nontraffic sensitive costs of subscriber plant equipment to federal accounts for every 1 percent of interstate calling.[26]

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[23] (...continued)
use) except that the toll minutes were weighed to reflect the fact that toll switching costs per minute of toll use are greater than the costs per minute of exchange use.

[24] Id. at 118 and 121.

[25] Prescription of Procedures for Separating and Allocating Plant Investment, Operating Expenses, Taxes, and Reserves Between the Intrastate and Interstate Operations of Telephone Companies, Recommended Report and Order, 26 FCC 2d 248 (1970). The specific formula is SPF = 0.85 SLU + (2SLU x CSR) where CSR is the composite station rate (a ratio that combines measurements of average initial three minute station charges and average lengths of haul for interstate toll calls). See Amendment of Part 67, Notice of Proposed Rulemaking and Order Establishing a Joint Board, 78 FCC 2d 837, 841 (1980).

[26] See MCI v. FCC, 750 F.2d 135, 137 (D.C. Cir. 1984).

Ostensibly, SPF was designed to compensate for the deterrent effect of toll rate schedules on interstate calling;[27] in other words, it was perceived as unfair to the interstate jurisdiction to allocate costs in simple proportion to actual minutes of local and long-distance minutes of calling because the different forms of tariffs imposed on local and long-distance calls purportedly would encourage the former calls and discourage the latter calls. No one appealed the Ozark Plan. At the time, AT&T was the only long distance carrier and, since it controlled the Bell Operating Companies, most of the inflated Ozark payments remained within its corporate family:[28] AT&T was sending about half of the revenues it collected straight back to the BOCs.

As demonstrated by Figure 1, these more than two decades of revisions to the Separations Manual aggressively increased the percentage of exchange plant allocated to interstate service. Such revisions, in turn, forced AT&T to set interstate rates high enough to cover the costs of the subsidized local plant. Such rates necessarily were much higher than the rates charged by a company not burdened with local plants nor with regulatory prices characterized by the use of historical costs, fully distributed pricing, nationwide averaging, and separations. Eventually, such government-mandated pricing created strong artificial

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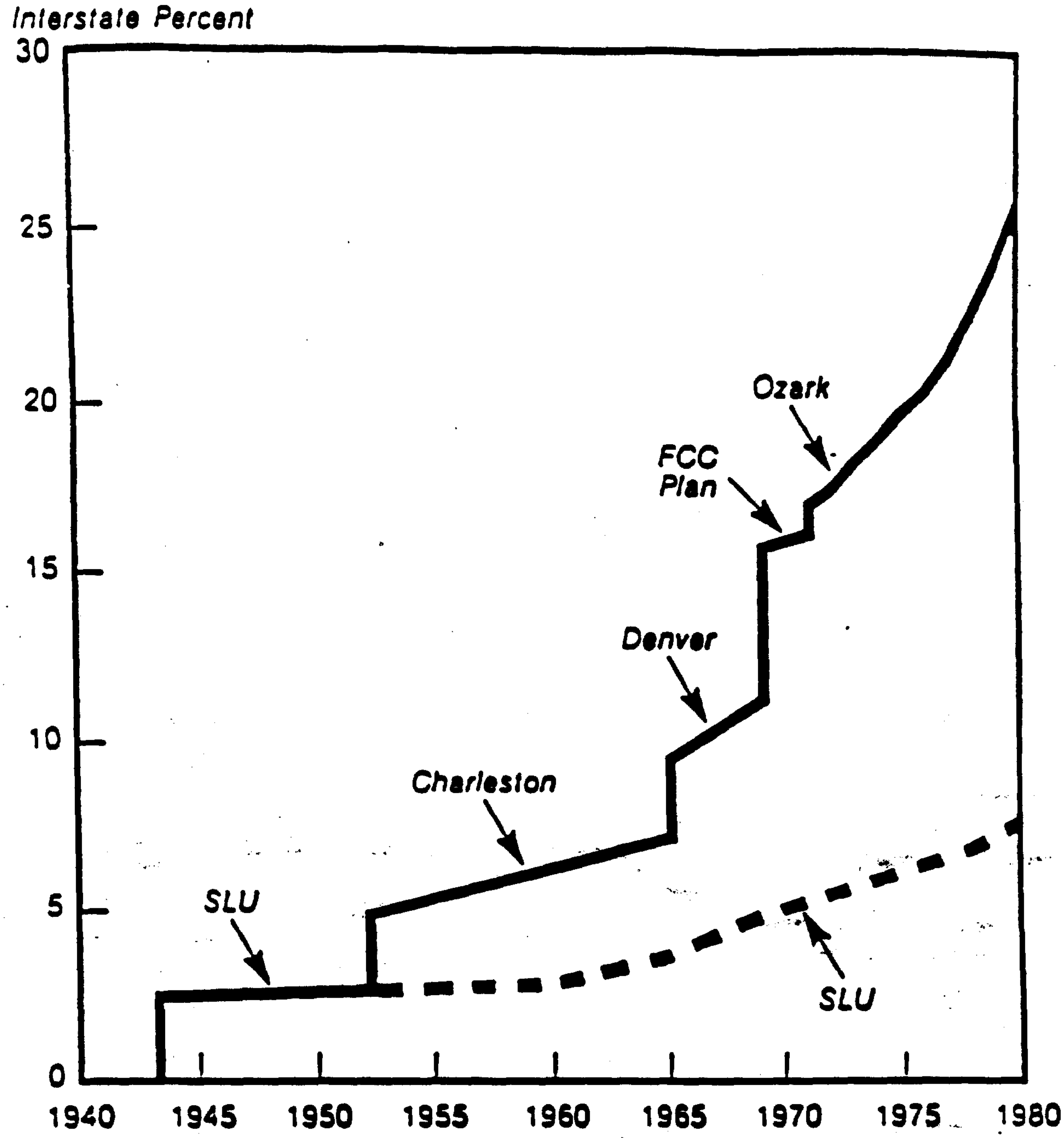
[27] 26 FCC 2d at 251. The "deterrent effect" was the result of the dichotomy between (1) the flat rate tariffs for exchange service that encourage unlimited local calling and unlimited local conversation time and (2) the measured rate pricing for toll service that purportedly tends to deter the telephone subscribers' use of the subscriber plant for toll services. See MCI v. FCC at 138, n.3 citing AT&T, Order, 9 FCC 2d 30, 102 (1967).

[28] AT&T's "settlement" payments to independent telephone companies gave them no incentive to appeal the plan either.




# Figure 1.

(Source: P. Temin, The Fall of the Bell System 1987 at 26.)

economic incentives for competitive entry into long distance and made such price/cost disparities increasingly untenable for AT&T.

## IV. 1980s: ATTEMPTS TO REFORM SEPARATIONS IN AN INCREASINGLY COMPETITIVE ENVIRONMENT

The steady rise in the proportion of local costs assigned to long distance increasingly made separations a major feature of telephone pricing. The interstate subsidy of local service reached over $7 billion in 1981 compared to total interstate revenues of $20 billion.[29] By 1983, it was estimated that 40 percent of interstate revenues were being used to keep local rates down.[30]

Following the adoption of the Ozark Plan, the telecommunications industry underwent several fundamental changes, including, perhaps most significantly, the increase in long distance service competition. In addition, AT&T's divesture of the BOCs enhanced that competition and created its own ripple effects of change.

The confluence of these changes created powerful incentives for AT&T to begin resisting the historic overallocation created by separations. Perhaps most obviously, with the divestiture of the BOCs, the local subsidy paid by AT&T no longer was an internal transfer remaining within the AT&T corporate family.

To add insult to injury, from AT&T's perspective, its competitors increasingly were able to enter, and remain in, the long distance market merely by undercutting AT&T's

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[29] Temin & Peters, "Cross-Subsidization in the Telephone Network," 21 Willamette Law Review at 199-223 cited in Temin at 306.

[30] Remarks of C. Brown, AT&T Annual meeting, Atlanta, Georgia, April 20, 1983 cited in Temin at 307.

interstate rates that were inflated by separations procedures.[31] Indeed, at least initially, these competitors could offer such service merely by leasing AT&T's own private lines at flat, NTS rates and offering service to the public via local service lines: the interstate subsidy of local NTS costs was recovered almost entirely from traffic sensitive charges on switched long distance services.[32]

Moreover, the newly-divested BOCs were also being adversely affected by separations. To the extent that the subsidy to local service was to continue to depend on interLATA traffic going through the operating companies, it would accelerate efforts to bypass their access facilities.

A. Treatment of SPF

To minimize these adverse effects, AT&T began to advocate the need for separations reform to better reflect the economic cost of regulated interstate services. AT&T argued that, principally as a result of the Ozark Plan's SPF factor, MTS/WATS usage was resulting in an assignment of NTS costs to the interstate jurisdiction at a weighting of a nationwide average of 3.3 times the relative use.[33] Moreover, even under the ENFIA rates, the MTS-like services offered by AT&T's long distance competitors were only defraying 35 percent of the NTS access costs that MTS was required to bear under the Separations Manual, although the use of their services was being treated similarly to MTS use for purposes of allocating costs to

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31 Moreover, such competitors had no economic incentive to price their services to reflect the true cost of the service, they merely priced at some level slightly below the inflated price that resulted from the use of SPF and other government-mandated uneconomic pricing mechanisms.

32 See Kellogg, Thorne & Huber, Federal Telecommunications Law at 457 (1993).

33 78 FCC 2d at 849.

interstate operations.[14] As a result. the allocation of interstate MTS/WATS revenue requirements was growing at a faster rate than MTS/WATS revenues. AT&T expressed growing concern that this increasing allocation to the interstate jurisdiction would lead to higher MTS/WATS rates, thereby giving further improper pricing signals to its long distance competitors.

In June 1980. the FCC established a Federal-State Joint Board to examine the separations treatment of NTS plant[15] and adopted the Joint Board's recommended proposals with minor modifications in February 1982.[16] Recognizing that the federal share of local NTS costs were grossly over-inflated. the FCC froze the total interstate contribution, SPF. at the average 1981 annual percentage levels, as an interim measure pending the development of comprehensive revisions in the separations procedures. This marked the end of the "three-for-one" Ozark Plan. While the freeze imposed a cap on the percentage of NTS costs allocated to the interstate jurisdiction, it allowed a growth in the absolute dollar allocation; thus as NTS costs increased because of inflation or additional investment, the interstate share of those total costs would also increase.[17]

MCI unsuccessfully challenged the FCC's imposition of the SPF freeze arguing that the NTS burden should have been reduced, not merely preserved at a level almost three times above what relative usage would dictate. In its decision, the Circuit Court ruled that the

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14/ Id.

15/ Id. at 837.

16/ Amendment of Part 67, Decision and Order, 89 FCC 2d 1 (1982).

17/ Id. at 13-14.

FCC's rationale for imposing the SPF freeze -- to preserve the Commission's ability to implement comprehensive separations revisions in a manner that would cause the least upheaval in the industry -- was reasonable.[38] The court went on to acknowledge that "[c]ost allocation is not purely an economic issue - it necessarily involves policy choices that are not constitutionally prescribed."[39]

The FCC subsequently concluded the use of SPF had increased the proportion of NTS plant allocated to the interstate jurisdiction dramatically above the level anticipated or intended in 1970.[40] The FCC also noted that the concomitant increase in interstate rates spurred the prospect of local services facilities bypass.

As part of its comprehensive separations reforms, the FCC ultimately reduced the allocation to the interstate jurisdiction caused by the SPF. In December of 1983, the FCC extended the SPF freeze until 1986 after which it was reduced to a 25 percent "base factor apportionment."[41]

B. Separations Amid Access Reform

The sharp disparities between prices and costs caused by decades of government-mandated separations subsidies became increasingly untenable as the Bell System was forced

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[38] 750 F.2d at 141.

[39] Id.

[40] 89 FCC 2d at 4. For example, the FCC noted that the proportion of subscriber plant costs assigned to interstate for the Bell System alone had grown by 50 percent since 1970. Id. at 5.

[41] Jurisdictional Separations Procedures. Decision and Order, 49 Fed.Reg. 7934 (1984).

to operate in a competitive marketplace.[42] To address this problem, the FCC established a Joint Board to determine "what reimbursement interstate services should make to local operating companies for the use of local plant" and "whether and how these charges can be equitably imposed on all interstate services."[43]

The separations and access charge reforms instituted in the 1980s went a long way towards remedying some of the more egregious cost/price disparities. An important first step in this effort was the introduction of limited flat-rated monthly charges assessed to all subscribers (subscriber line charges) to recover some of the interstate nontraffic sensitive costs that had been bundled into the per-minute rates for access service.[44]

1. Retention of Residual Cost/Price Disparities

However, even at the time such reforms were adopted, all parties concerned, including the FCC, were keenly aware that significant cost/price disparities remained. In virtually every instance in which reforms were contemplated, both the FCC and the Joint Board requested the LECs to provide "price-outs" to test the state/interstate revenue requirement shifts that would

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[42] For example, the overallocation of nontraffic sensitive costs to the interstate jurisdiction creates uneconomic costing problems for regulated carriers that are not faced by their competitors. As a consequence, these competitors are able to enter and remain in the market merely by underpricing the rates needed to recover the government-mandated subsidies. Moreover, as a carrier's customers drop-off the public switched network, the carrier has fewer revenues with which to contribute to the government-mandated subsidies.

[43] MTS and WATS Market Structure, Notice of Inquiry and Proposed Rulemaking, 67 FCC 2d 757, 759 (1978).

[44] To the extent that carriers are still required to recover interstate nontraffic sensitive allocations on a per-minute of use basis (i.e., via the carrier common line charge), they are forced by government fiat to recover nontraffic sensitive costs in an uneconomic fashion. The carrier common line charge is that portion of nontraffic sensitive costs not recovered from subscriber line charges.

result from the proposed reform. Indeed, decisionmakers often were more concerned with adopting proposals that created the least jurisdictional impact than implementing the most economically efficient reforms.

An example of this phenomenon was the separations treatment of Account 645, Local Commercial Operations costs.[45] In 1984, the New York Public Service Commission alerted the FCC and the Joint Board that, under the separations rules then in effect, AT&T's assumption of billing inquiry services previously provided by the LECs would cause a sudden and substantial reassignment of Account 645 costs to the intrastate jurisdiction.[46] This reassignment was caused by the fact that under these rules, the level of Account 645 costs assigned to the interstate jurisdiction was largely a product of the customer contact factor.[47] However, responding to end user billing inquiries involved a very small portion of local commercial work time.[48] Thus, AT&T's provision of its own billing inquiry service would reduce the number of local commercial office contacts related to interstate toll messages, thereby lowering the interstate cost assignment, without producing an offsetting reduction in

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[45] Account 645 reflected the costs involved in maintaining the local commercial operations of the telephone company other than promotional or directory services.

[46] Prior to that time, LECs performed the billing and collection, including billing inquiry services, for both local telephone service and long distance toll calling carried over AT&T's network.

[47] The customer contact factor is the relative number of business office contacts relating to state toll and interstate toll messages and was used as the allocation factor under the separations rules in effect at that time.

[48] See MTS and WATS Market Structure, Memorandum Opinion and Order, 1 FCC Rcd. 1216 at para. 3 (1986). Moreover, the interstate customer contact factor had been developed from a formula based on relative revenues rather than the use of actual accounts or samples of contacts. See MTS and WATS Market Structure, 60 Fed.Reg. 2d 1345 at para. 12 (1986).

total local commercial office costs. The jurisdictional shift was far in excess of the costs that LECs would save by discontinuing their billing inquiry service and underscored the jurisdictional misallocation of costs that had been produced by the then existing separations procedures.

The Joint Board[49] and the FCC[50] acknowledged that excessive Account 645 costs had been allocated to the interstate jurisdiction, but in light of the potentially abrupt jurisdictional shift, decided that, as an interim measure until permanent measures for the allocation of Account 645 were adopted, the interstate allocation of these costs should be frozen and then gradually phased down over a twelve month period to approximately one-half of the pre-existing level. The affected BOCs' were ordered to adjust their access charge tariffs to reflect these changes. These tariffs were later allowed to go into effect over the objections by AT&T that the BOCs had allegedly failed (1) to reduce their billing and collection rates to reflect correctly the transfer of certain costs from pre-existing billing and collection rate elements to the new interim traffic sensitive rate element and (2) to comply with the phased down Account 645 and related costs assigned to the interstate jurisdiction.[51] As a consequence, although acknowledging that Account 645 allocated a disproportionate amount of costs to the

[49] MTS and WATS Market Structure, Mimeo No. 3400 (released March 25, 1985), 50 Fed.Reg. 14729 (April 15, 1985).

[50] MTS and WATS Market Structure, 50 Fed.Reg. 26204 (June 25, 1985), recon., 60 Fed.Reg. 2d 1345 (adopting the Joint Board's recommended interim separations procedures);MTS and WATS Market Structure, Decision and Order, FCC No. 86-5 (released January 7, 1986), 51 Fed.Reg. 3176 (January 24, 1986), recon., 1 FCC Rcd. 1216 (adopting the Joint Board's reasoning for such procedures).

[51] New England Telephone and Telegraph Company et al., Order, 1986 FCC LEXIS 2932 (released August 5, 1986).

inflated interstate jurisdiction, the FCC and Joint Board perpetuated it for at least a year thereafter. Even when the FCC eventually adopted permanent changes to the allocation of Account 645 expenses,[52] it anticipated that these new separations procedures would decrease, but not eliminate, the inflated interstate allocation of Account 645.[53]

### 2. Retention of the Local Subsidy

Even in the midst of the separation reforms, the Joint Board and the FCC were very much aware of, and always discussed and considered, the potentially adverse policy ramifications of moving too many dollars to the intrastate jurisdiction. There was a widespread understanding that it was not politically possible to move all, or even most, of the true costs of local service to the state side of the ledger, and that those costs that were moved should be done so only through a gradual process,[54] thereby perpetuating significant portions of the local subsidy.

Decisionmakers realized that if all of the true costs of local service were allocated to the intrastate jurisdiction, state regulators might act on their traditional instincts to avoid

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[52] See, 60 Red.Reg. 2d at n. 22. The rules became effective on January 1, 1987. They were originally due to become effective on June 1, 1986. 51 Fed. Reg. 3176. In 1986, the FCC preemptively detariffed the LECs' provision of billing and collection [illegible] interexchange carriers. In 1987, the FCC decided to continue to apply the [illegible] separations process to billing and collection service costs to identify inve[illegible] that are properly attributable to intrastate activity. It anticipated that the de[illegible] and collection would not shift costs between the state and interstate jurisdictions, but that it would merely remove some interstate costs from the regulated arena. Detariffing of Billing and Collection, 102 FCC 2d 1150 at para. 48 (1986).

[53] See 60 Fed.Reg. 2d at para. 21.

[54] The deliberate transitional nature of moving intrastate costs to the state jurisdiction was designed to prevent "rate shock" to residential customers of local service. "Rate shock" was typically understood to mean a rapid increase in the price of residential customers' local rates.

raising residential rates (ostensibly to avoid threatening universal service, but also to avoid alienating their residential constituents) at all costs. To cover such costs, state regulators might inflate intrastate, interLATA rates (which would stymie the growing competition in the long distance market) or prevent the local telephone companies from raising prices to cover these costs (risking confiscation if such carriers were not allowed the opportunity to earn a reasonable return on their investment and/or preventing such carriers from investing in the network to the ultimate detriment of the public network and consumers).

The potential for such uneconomic, inefficient pricing and the threat to the longterm reliability of the public network were motivating factors for (1) not identifying the true costs of local service that were included in interstate accounts and that could be moved to the intrastate jurisdiction, and (2) using allocators which everyone knew did not reflect the true relative use of the service. Instead, decisionmakers merely targeted for reform the interstate accounts with the largest price/cost m[illegible]oard deliberately maintained the interst[illegible]

An example of this pheno[illegible] expenses. Under Part 67, marketing expenses [illegible] the jurisdictions on the basis of local and toll revenues. In revising the Separations Manual in 1987, the Joint Board recommended, and the FCC adopted, new procedures that allocated marketing expenses on the basis of revenues excluding access revenues.[22] In their petitions for reconsideration of that order, several LECs argued that a significant shift ($475 million) in revenue requirement to the state jurisdiction would result from the exclusion of access charges in contravention of the

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22/ MTS and WATS Market Structure, Report and Order, 2 FCC Rcd 2639 (1987).